Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Developing a Unified Intercarrier	)	CC Docket No. 01-92
Compensation Regime	)	

Comments of the
Ad Hoc Telecommunications Users Committee

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Summary

The Ad Hoc Telecommunications Users Committee ("Ad Hoc") supports adoption of a single, economically rational intercarrier compensation regime. Carriers currently pay each other vastly different rates for functionally the same origination and termination services. This situation is economically irrational and distorts investment and purchase decisions. The distortions inevitably produce economic loss that harms buyers of telecommunications goods and services and the country more generally. Lower usage-sensitive access charges, accompanied by some increase in Subscriber Line Charges, would be justified. Elasticity of demand studies suggest that "affordability" concerns do not justify retention of the existing system. With one exception, explained below, the Commission should not allow the current hodgepodge of intercarrier compensation mechanisms to persist.

The Commission cannot rely on the marketplace to produce an economically rational intercarrier compensation regime. The Commission's own decisions and evidence first submitted by the Ad Hoc Telecommunications Users Committee and then AT&T attest to the de facto market power that incumbent local exchange carriers hold. Accordingly, absent Commission oversight, the chance of avoiding excessive prices for origination and termination of traffic bound for and coming from other local exchange carriers is virtually nil.

The entire Further Notice of Proposed Rulemaking (FNPRM) is focused on intercarrier compensation for switched traffic. The FNPRM manifests no concern about the prevailing, grossly excessive special access rates. Carriers

can use excessive special access rates to exert price squeezes on competitors and to gouge end users. Ad Hoc once again pleads with the Commission to reduce special access rates to proper cost-based levels.

Ad Hoc objects to proposals that include elements intended to maintain current revenue flows to rural local exchange carriers (RLECs). Ad Hoc does not doubt that RLECs derive a material portion of their revenues from access charges and universal service payments. That, however, is far from justification for a "make whole" component. The Commission cannot reasonably conclude that current revenues are cost-driven. Ad Hoc and other parties have questioned the cost-basis for the ever-growing high cost component of the universal service fund, and the Commission has yet to come to grips with this problem. Certainly, there is no evidence that RLECs would experience rates-of-return below the just and reasonable range. Nor is there a statutory basis for maintaining existing revenue levels without cost justification.

Nevertheless, Ad Hoc is mindful of the difficult problem presented by the RLECs. The Commission has had insufficient resources to audit RLECs and state regulatory authorities do not have an incentive to conclude that the RLECs have overstated costs so long as interstate universal service subsidies flow based on reported costs and the RLECs do not seek intrastate rate increases. Moreover, the level of economic distortion attributable to RLEC intercarrier compensation charges is relatively small compared to the distortions caused by intercarrier compensation charges levied by larger local exchange carriers. Accordingly, Ad Hoc suggests that the Commission defer imposing a new, unified intercarrier compensation regime on RLECs at this time. The Commission can gain some experience with the new system and tackle the underlying problems with the high cost component of the universal service fund before further increasing the size of the universal service fund.

The Commission must recognize that the intercarrier compensation proposals that would reduce usage-sensitive access charges paid by long distance carriers because of material increases in end user line charges inequitably and adversely affects end users who are parties to multi-year term contracts with long distance carriers. These end users will not be able to use the market to try to benefit at least to some degree from the long distance carriers' access charge reductions through long distance rate reductions because they are under contract to long distance carriers. The public interest mandates that such end users be given a 180 day "fresh look" opportunity to use the market to negotiate some measure of flow through of the switched access charge reductions. During this "fresh look" window, end users could seek to renegotiate existing contracts. At the end of the "fresh look," if they have been unsuccessful in renegotiating their long distance contracts, they would have the opportunity to terminate their contracts without liability, except for charges for services provided, or to stay with their existing contracts. The Commission has previously afforded end users a fresh look to advance the public interest. Ad Hoc asks only for equitable treatment, particularly given past Commission action that allowed carriers to reform contracts because of a new universal service contribution obligation, which was at least partially offset by lower access charges.

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The Ad Hoc Telecommunications Users Committee (hereinafter "Ad Hoc" or the "Committee")[1] hereby submits its comments in response to the Commission's March 3, 2005 *Further Notice of Proposed Rulemaking* (*FNPRM*) in the above-captioned docket.[2] Ad Hoc agrees that the Commission should replace "[t]he existing patchwork of intercarrier compensation rules with a unified approach."[3] While much of the *FNPRM* focuses on the effects of various approaches to intercarrier compensation on wholesale relationships, little in the *FNPRM* discusses the impact on end users.[4] Accordingly, these comments provide an enterprise customer perspective on issues raised in the *FNPRM*.

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[1] Ad Hoc is an unincorporated, nonprofit entity that accepts no carrier funding and exists to represent its members' interests in telecommunications matters pending before governmental authorities. Ad Hoc's members are all substantial purchasers of telecommunications services, and are considered "enterprise customers" within the telecommunications industry. Fourteen of Ad Hoc's nineteen members are in the Fortune 500.

[2] *Developing a Unified Intercarrier Compensation Regime,* CC Docket No. 01-92, FCC 05-33 (rel. Mar. 3, 2005).

[3] *FNPRM*, para. 3.

[4] Although paragraph 4 of the *FNPRM* solicits comment on, *inter alia*, the "end-user effects" of industry proposals for reform of current intercarrier compensation structures, the balance of the *FNPRM* offers little evidence of concern regarding "end-user effects."

I. This Proceeding Is About End Users, As Well As Providers.

The *FNPRM* articulates a number of goals for a sound intercarrier compensation regime, including: promotion of economic efficiency,[5] preservation of universal service,[6] competitive and technological neutrality[7] and regulatory certainty.[8] Presumably, the Commission also seeks to assure that the rates that carriers impose on end users upon implementation of a new intercarrier compensation regime will be just and reasonable.[9] All of these goals are completely consistent with the Commission's ultimate responsibility of protecting and advancing the public interest, which, of course, extends far beyond balancing the interests of the various service providers.

Nothing in the *FNPRM*, however, acknowledges the importance of setting special access rates at proper, cost-based levels to the furtherance of the aforementioned goals. Ad Hoc has repeatedly pled for the Commission to reduce existing special access rates, and has repeatedly explained that current market forces are inadequate to assure just and reasonable special access rates.[10] The Committee does so yet again in this pleading. Excessive special

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5 *FNPRM*, para. 31.

6 *Id.,* para. 32.

7 *Id.,* para. 33.

8 *Id.*

9 *See* 47 USC §201(b).

10 *See, e.g.*, Ad Hoc Comments in *Performance Measurements and Standards for Interstate Special Access Services,* CC Dkt. Nos. 01-321, 00-51, 98-147, 96-98, 98-141, 96-149, 00-229, Notice of Proposed Rulemaking, 16 FCC Rcd 20896 (2001) (comments filed Jan. 22, 2002, reply comments filed Feb. 12, 2002); *Review of Regulatory Requirements for Incumbent LEC Broadband Services; SBC Petition for Expedited Ruling That It Is Non-Dominant in its Provision of Advanced Services and for Forbearance From Dominant Carrier Regulation for Theses Services,* CC Dkt. No. 01-337, Notice of Proposed Rulemaking, 16 FCC Rcd 22745 (2001) (comments filed Mar. 1, 2002, reply comments filed Apr. 22, 2002); *Appropriate Frame work for Broadband Access to the Internet Over Wireline Facilities,* CC Dkt. Nos. 02-33, 95-20, 98-10, Notice of Proposed Rulemaking, 17 FCC Rcd 3019 (2002) (reply comments filed Jul. 1, 2002);

access charges indisputably undermine economic efficiency because such rates send false price signals and thus distort efficient purchase and use of the nation's telecommunications services. Moreover, the comments of some parties on the pending applications regarding SBC's acquisition of AT&T explain persuasively how carriers such as SBC and Verizon can use excessive special access pricing to create a price squeeze effect and to geographically segment the market.[11] Such an outcome would be inconsistent with the competitive goals of the Telecommunications Act of 1996.

Excessive special access rates, as well as the current patchwork of intercarrier compensation mechanisms, developed on the Commission's watch. Just as the Commission recognizes the need to move to a unified, economically rational intercarrier compensation regime for switched traffic, so too should it move quickly to conclude the long requested re-setting of special access rates. Only when both are done, will the praiseworthy goals of this proceeding be well-served.

II. The Commission Should Replace Current, Disparate Payment Mechanisms With A Uniform Plan.

As the Commission noted in the *FNPRM,* "identical uses of the network" are treated differently, "even though such disparate treatment usually has no economic or technical basis"[12], resulting in "regulatory arbitrage."[13] Differing rate

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and *AT&T Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593 (comments filed Dec. 2, 2002).

[11] *See, e.g.,* Opposition of Broadwing and SAVVIS, WC Dkt. No. 05-65 (filed Apr. 25, 2005) at Part V.E.; Comments of Global Crossing at 20-21.

[12] *FNPRM*, at para. 15.

levels for identical functionalities necessarily result in market distortions, impacting originating and terminating carriers' incentives to enter into wholesale agreements of various types, as well as connecting carriers' design and offering of telecommunications service products. The flawed pricing systems ultimately impact the kinds of service packages that are offered to end users like the Committee's members.

Throughout its long history of participation in FCC ratemaking, and more specifically access charge proceedings, Ad Hoc has always endorsed the principle of cost-based pricing. Cost-based pricing of telecommunications service, when combined with a well-conceived and properly implemented universal service program best serves the goals of economic efficiency and equity. Fortunately, at the present, there seems to be no dispute that the costs associated with the provision of originating and terminating interconnection are the same, regardless of the jurisdictional nature of the traffic.[14] The problem at hand is how to get all of the rates to the same level.

While the persistence of excessive, non-cost-based access charges may have perhaps been tolerable in the past (insofar as it was intended to achieve wide availability of basic local exchange service), the evolution of competing technologies, such as IP telephony, and entry by the BOCs into the interexchange service business make above-cost access charges inimical to

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13 *Developing a Unified Intercarrier Compensation Regime,* CC Dkt. No. 01-92, Notice of Proposed Rulemaking, 16 FCC Rcd 9610, 9616 (2001) ("*NPRM*"), para. 12 and *FNPRM*, at para. 15.

14 *See* Comments in response to the *NPRM,* CC Dkt. No. 01-99 (filed Aug. 21, 2001): AOL Comments at 2-3, Global NAPS Comments at 7, Level 3 Comments at 25-26, AT&T Comments at 1.

competition and a source of serious distortions in both the technology and provider choices made by users.

Interconnection charges can be a major component of overall service costs – in some cases representing as much as 40% to 50% of the ultimate retail price of a service. Continuation of the current hodge-podge of pricing schemes wherein some, but not all, forms of interconnection are priced dramatically in excess of costs will of necessity impact infrastructure investment, service design, and ultimately end-user purchase decisions. Network topology and technology choices should be driven by real differences in the economic costs of providing end-to-end service, not by distorted interconnection rates induced by a flawed regulatory system

End-user customers attempting to make rational choices between network platforms, access methods and service packages are hampered in their ability to do so as a result of these regulatorily-induced distortions. Each day that this problem goes on, some U.S. business somewhere is making a long-term technology choice, investing in hardware, changing systems, attempting to make the most economical purchase decision based upon the pricing information available in the market. But that pricing information is distorted because the underlying wholesale prices favor some technologies and service platforms over others – meaning that rational choices are not necessarily being made.

Consider that the terminating charge for a 10-mile call could be "local," and subject to reciprocal compensation rates if the interconnection is between LECs, or it could be priced as much more expensive "intrastate access" if it is first delivered to an IXC and then handed off to a LEC for termination. Competitive impacts aside, the result for an enterprise customer attempting to minimize costs is that it is required to purchase additional facilities that allow the segregation of traffic. Instead of having all outbound traffic go directly to an IXC POP over a single dedicated facility, the pricing distortions in the wholesale market often make it less expensive for the enterprise customer to separate out and deliver it to a LEC over a second, otherwise unnecessary, transmission facility.

These distortions impact competitors and their ability to function in the market as well. A call that travels as far as fifty miles and is carried across a state boundary could be billed as local if it is delivered by a wireless carrier and is located within a wireless MTA, or at a much higher interstate access price if it is handed off by an IXC – giving the wireless carrier a clear cost advantage in the offering of its toll services over the land line service. While the correct interconnection treatment of calls transmitted using Voice over Internet Protocol (VoIP) is still being litigated, the competitive advantage that would be afforded a VoIP toll-service provider that does not have to pay access charges vis-à-vis a circuit-switched provider that does is substantial enough to cause both competitors and customers to entertain plans to adopt VoIP aside and apart from other IP-platform advantages.

The ability to determine what interconnection charge should apply under the current system is also becoming more difficult. As an example, SBC offers a new service to customers that subscribe both to SBC local service and service from SBC's wireless arm, Cingular. The new service, called "Fastforward" allows customers to utilize a special phone "cradle" that automatically reroutes incoming wireless calls to the customer's SBC landline phone, allowing the customer to receive calls placed to their wireless number without incurring airtime charges. Product information from SBC's website on the "Fastfoward" service is included as Attachment A. Does the fact the call is terminated on an SBC customer's landline phone change the nature of the call? An interconnecting carrier involved in the origination of a call to Cingular for completion to a customer using "Fastforward" would have no way of determining how that interconnection should be billed. If the call termination would be within the wireless MTA, but outside the landline local calling area and it is completed as a landline call should the call originator collect an access charge? SBC's service is but one example of the blurring lines between different interconnection options and the need for uniform system of charges.

Allowing the existing array of uneconomic intercarrier compensation schemes to continue would cause even greater economic and operational distortions. The Commission should do all that it can to eliminate such distortions – distortions that clearly are undesirable in the current hyper-competitive global economy.

III. The Commission Should Not Rely On The Hope Of Competition To Regulate And Normalize Charges For The Origination And Termination Of Traffic.

In various places throughout the *FNPRM* the Commission questions whether it can rely upon competition to set and regulate interconnection prices,[15] and any alternative recovery mechanism used to compensate LECs for reduced interconnections charges (*e.g.*, SLCs, USF).[16] The answer to both of those questions is a resounding "no." As Ad Hoc demonstrated in its August 2004 white paper, *Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Uncertain Markets,*[17] real and/or potential competition has not been sufficient to discipline LEC pricing practices to date.

The August 2004 white paper found that premature deregulation of special access services in advance of the development of competition sufficient to discipline LEC pricing has resulted in special access services priced significantly above cost. In other words, the potential that competitors might deploy services to enterprise customers has not been sufficient to constrain LEC behavior. In fact, based upon year-end 2003 data, Economics and Technology (ETI), Ad Hoc's economic consultant, was able to quantify that every day that the FCC allowed to pass before reducing the LECs' special access rates costs business and government users more than $15-million.[18] And the situation is only getting worse. Special access rates during calendar year 2004 generated some $6.4-

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15 *FNPRM,* paras. 33 and 116.

16 *FNPRM,* para. 101.

17 *Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Uncertain Markets*, ("*Reality or Illusion*"), Economics and Technology, Inc. (Aug. 2004), submitted by Ad Hoc in CC Dkt. Nos. 00-175, 01-337, 04-36, 02-33, 95-20, 98-10, 01-321, 00-51, 98-147, 96-98, 98-141, 96-149, 00-229, 01-338, 03-173, WC Dkt. Nos. 02-112, 04-242, RM-10593, and RM-10329.

18 *Id.*, at iii, and 7-8.

billion in excessive special access revenues, $17.5-million per day. This means that the amount by which corporate users of special access services were being overcharged in 2004 increased by approximately 15% over the already excessive 2003 levels.[19]

Nor do intermodal competitive alternatives exist to discipline interconnection charges for switched access service. If, in fact, intermodal competitive alternatives did exist at levels sufficient to impact LEC pricing, the differentials between interconnection rates of different types would have already been substantially eliminated. But such is not the case. Evidence presented in *Reality and Illusion* documents that contrary to the FCC's expectations at the time the CALLS order was adopted, competition has not forced further decreases in switched access charges. In fact, the average switched access price per minute of use has *increased, not decreased*, once CALLS-mandated rate decreases were stopped.[20]

The Commission itself has found that marketplace alternatives do not exist at the point at which a carrier needs to obtain call origination and termination service to reach a customer. The finding of what is in essence a very localized monopoly was at the heart of the Commission's decision in the *CLEC Access Charge Order.*[21] In that proceeding the Commission was examining the conditions that IXCs faced in purchasing "access service as an input for the long

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19 See, Ad Hoc Reply Comments, CC Dkt. No. 05-65, Declaration of Susan M. Gately, para. 6.

20 *Reality or Illusion*, at 38-40 and Table 3.3.

21 *Access Charge Reform; Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, CC Dkt. No. 96-262, Seventh Report and Order and Further Notice of Proposed Rulemaking, 16 FCC Rcd 9923 (2001) ("*CLEC Access Change Order*").

distance service that they provide to their end users."[22] The specific concern at the time related to CLEC access charges. However, the monopoly condition that the FCC found faced IXC customers of CLECs is relevant to all parties that attempt to Interconnect to an end user customer of another carrier. The FCC found that "IXCs are subject to the monopoly power that CLECs wield over access to their end user" and "given the unique nature of the market in which IXCs purchase CLEC access, however, we conclude that it is necessary to constrain the extent to which CLECs can exercise their monopoly power and recover an excessive share of their costs from their IXC access customers – and, through them, the long distance market generally."[23] In the absence of marketplace alternatives, the Commission cannot reasonably rely on negotiated agreements to set the rates, terms and conditions for the origination and termination of traffic destined to or coming from other networks.

IV. The Commission Should Not Adopt Inter-Carrier Compensation Rules That Assure Existing Revenue Levels.

The *FNPRM* seeks comment on several proposals and numerous issues that it groups under the heading "Cost Recovery Issues."[24] The real issue, however, is not cost recovery; the real issue is the extent to which the Commission will assure existing "revenue" levels.

The *FNPRM* recognizes that, "Many of the reform proposals include mechanisms by which some carriers will be permitted to offset revenues

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22 *Id.*, para. 38.

23 *Id.*, at paras. 38 and 39.

24 *FNPRM*, paras.32, 43, 46, 48, 53, 98-113.

previously recovered through interstate access charges."[25] The ICF plan, the Expanded Portland Group plan, and the Alliance for Rational Intercarrier Compensation solution are examples of proposals that contain revenue stream assurance features. Other parties oppose proposals that, "include revenue guarantees or assumptions concerning revenue neutrality."[26] In the same paragraph, the Commission then asks, "What is the Commission's legal obligation to provide alternative cost recovery mechanisms?" In the next paragraph, the Commission asks whether it is, "[l]egally obligated to make any transition to a new compensation regime revenue neutral for the affected carriers."[27] Ad Hoc believes that the Commission appreciates the difference between cost recovery and revenue neutrality. Although the two concepts might seem to be used interchangeably, the Committee believes that was not the Commission's intention. Consequently, Ad Hoc addresses cost recovery and revenue neutrality separately.

A. Alternative Cost Recovery Mechanisms Are Not Needed.

There is no evidence that local exchange carriers would be unable to earn reasonable rates of return if the Commission adopts an intercarrier compensation model that significantly reduces access charges. That is the case with respect to price cap carriers and rate of return carriers.

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25 *Id.,* para. 99.
26 *Id.*
27 *Id.,* para 100.

Case law teaches that it is the effect of a rate order that determines whether a regulatory authority has acted unlawfully.[28] Even if a new intercarrier compensation regime reduces carriers' revenues, the carriers still must demonstrate that they would be unable to realize a reasonable rate of return as a result of such an order. Carriers claiming to need to recover costs, should be required to make showings that include, but may not be limited to, (1) allocation of costs between regulated and unregulated services and between the intrastate and interstate jurisdictions, (2) the usage sensitive access revenue lost as a result of a new intercarrier compensation regime, (3) the demand stimulation effect of lower access charges (4) the revenue effect of increased line charges authorized by the Commission, (5) other possible rate changes and their effect on revenues, (6) anticipated revenues and earnings after implementation of new intercarrier compensation rules, taking into account all carrier revenues and earnings, and (7) the rate of return deemed reasonable given the risks and market conditions confronting the carrier. To the best of Ad Hoc's knowledge, carriers have not made such showings. These showings would not be easily made, but would be necessary before the Commission could reasonably adopt, or allow carriers to implement, a rate element or draw more money from the Universal Service Fund (USF) to "recover costs."

The Commission may not rely on existing revenue levels as a measure of reasonable cost recovery. Western Wireless in another proceeding has asserted that, "[n]o comprehensive audit of the regulatory accounts of the vast majority of rural ILECs has been conducted in the past decade, either by the FCC, state

[28] *Duquense Light Co. v. Barasch,* 488 U.S. 299, 310 (1989).

commissions, NECA, the Universal Service Administrative Co. (USAC), or independent auditors retained by the ILECs themselves."[29] Western Wireless also demonstrated that RLECs have opportunity and incentive to misallocate costs in ways that would '[i]mproperly augment universal service disbursement and 'pad their rates.'"[30] Ad Hoc urged the Commission to start the rulemaking sought by Western Wireless. Ad Hoc reasoned that despite the fact that states are, "[t]o file annual certifications with the Commission to ensure that carriers use universal service support 'only for the provision, maintenance and upgrading of facilities and services for which the support is intended' consistent with section 254(e)," the certification requirement has not produced the level of regulatory oversight needed to prevent cost misallocations.[31] The bottom line is that the Commission has no reasonable basis on which to assess the LECs' current level of earnings or their projected earnings after implementation of new intercarrier compensation rules. Neither price cap ILECs nor rate of return RLECs have provided the data needed to support a Commission finding that additional cost recovery would be needed because of implementation of new intercarrier compensation model.[32]

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29 Western Wireless Petition for Rulemaking, *Elimination of Rate-of-Return Regulation of Incumbent Local Exchange Carriers,* CC Dkt. No. 96-45 and RM-10822 (filed Oct. 30, 2003), at 26 (footnote omitted) ("*Western Wireless Petition*").

30 *Id.*

31 Ad Hoc Comments on *Western Wireless Petition* at 6-7 (filed Jan. 16, 2004).

32 Price cap LECs, of course, do not operate under a cost of service regulatory regime. They may seek a low end adjustment to their Actual Price Indices if their earnings fall below the just and reasonable zone. None of the RBOCs, however, will likely seek a low end adjustment given that their interstate rates of return range from almost 20% to almost 29% for calendar year 2004. Source: FCC, ARMIS Report 43-04, Access Report: Table I, YE 2003 Accessed April 7, 2004 & YE 2004 Accessed May 9, 2005. Available at http://www.fcc.gov/wcb/eafs/.

B. A Revenue Neutrality Mechanism Is Not Justified.

Nor have the proponents of several of the pending proposals that include revenue recovery, as distinguished from cost recovery, justified such revenue recovery. The *FNPRM* manifests Commission awareness that it cannot simply require revenue neutrality. At paragraph 103 of the *FNPRM* the Commission asks parties to discuss the type of findings that it must make "[b]efore using additional universal service funding to offset lost access charge revenues." Certainly, the Commission is not legally required "[t]o make any transition to a compensation regime revenue neutral for the affected carriers."[33] None of the applicable statutory provisions require revenue neutrality. The Commission may not require carriers to offer service at rates that would fail to yield adequate returns,[34] and section 254 of the Communications Act of 1934, as amended, sets out universal service requirements. But none of the parties have made the showings that would be needed to require revenue neutrality to satisfy the requirements of sections 201 and 254. Although some rural local exchange carriers (RLECs) may experience reduced revenues, a showing of reduced revenues is far from a showing that such carriers will not be able to offer services that are reasonably comparable to the services offered in urban areas at rates reasonably comparable to the rates charged in urban areas.[35]

The Commission should come to grips with the high cost problem that is driving Universal Fund growth and a seemingly ever higher USF factor before it leaps to maintain current RLEC revenues in a new intercarrier compensation

[33] *FNPRM*, para. 100.
[34] 47 USC §201(b).
[35] *See,* 47 USC §254(b).

regime. It simply makes no sense for the Commission to dramatically increase the amount of USF subsidies flowing to RLECS because the RLECs want to maintain their current revenue levels and some parties are willing to make major compromises to RLEC interests, apparently believing that absent some accommodation of the RLECs meaningful reform of the intercarrier compensation system is impossible.

C. The Commission Should Defer Applying New Intercarrier Compensation Rules To The RLECs.

In January of this year the Progress and Freedom Foundation (PFF) released a Special Report entitled *The Myths and Realities of Universal Service: Revisiting the Justification for the Current Subsidy Structure* (hereinafter the *Report*). Among the points made by the PFF Report are the following:

- Total high cost disbursements have doubled from $1.7 to $3.3 billion from 1999 to 2003 and are forecast to climb to $3.9 billion by the end of 2005. *Report at 106-107.*
- The Interstate Common Line Support (ICLS) and the Interstate Access Support (IAS) have grown from the time they were initiated (2002 and 2000, respectively) from $173 million and $283 million to estimated levels of $1,127 million and $746 million in 2005. *Report at 107, Exhibit IV.2.A.*
- The funding mechanism provides an incentive to be inefficient and provides no incentive to aggregate operations to achieve economies of scale. *Report at 110.*

- Because the USF is currently collected as a surcharge on interstate long distance calls, the effective price of long distance calls is raised (via the surcharge) in order to lower them through lower access charges paid by long distance carriers. *Report at 109-110.*

The PFF believes that reform is overdue. Ad Hoc agrees with the PFF on this point. The PFF acknowledges that reform of the existing Universal Service regime will be difficult, but not impossible, given "political realities." *Report at vii.* Again, Ad Hoc agrees with the PFF. The Commission should make decisions regarding such reform before it even considers further expansion of the USF in the name of revenue neutrality for the RLECs. The Commission should not make the current USF "mess" even worse by increasing USF payments to RLECs to assure revenue neutrality.

The Commission should defer a decision on whether to include rate of return RLECs in a reformed intercarrier compensation regime that would materially lower access service rates. The Commission has asked the Federal-State Joint Board on Universal service to study possible changes to the five-year plan adopted in the *Rural Task Force Order,* 16 FCC Rcd 11244 (2001).[36] That undertaking could lead to significant changes to the bases for USF payments to RLECs and the amount of such payments. Deferring a decision on whether and how to include rate of return RLECs in a new intercarrier carrier compensation scheme at this time would almost certainly avoid unnecessary market churn. Moreover, deferring a decision on whether to apply new intercarrier

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[36] *Federal-State Joint Board on Universal Service,* CC Dkt. No. 96-45, Order, 19 FCC Rcd 11538 (rel. Jun. 28, 2004). Order directs the Joint Board to study changes to the rural High Cost Fund, to be effective after June 30, 2006.

compensation rules to RLECs would give the Commission experience with the operation and effects of the new rules before applying them to the carriers who claim to be most adversely affected by changing the current intercarrier compensation system. The economic distortion that would continue by maintaining the status quo for the RLECs while the Commission wrestles with the high cost problem and gains experience with a unified intercarrier compensation regime would be relatively small given the offsetting benefits derived from deferral.

D. Any Assessment Mechanism Designed to Recover Lost Switched Access Revenues Should Not Apply to Dedicated Special Access Services.

If the Commission incorrectly determines that it should adopt an alternate funding mechanism to cover lost switched access service revenues, it should not recover such revenues from special access services. Special access services do not utilize LEC switching equipment, and in fact are in many cases substitutes for the switched access charges. Large commercial enterprises, like Ad Hoc's members, rely heavily on special access services for the dedicated, "final mile" connections that make up their private corporate networks, specialized data systems, and high-capacity, mission-critical transmission facilities at locations with heavy traffic volumes. Special access services have become an increasingly important part of the U.S. economy. During the last five years, as the number of interstate minutes being carried over the public switched network declined by almost 20% from 552 billion to 444 billion,[37] the number of special access voice-grade equivalent (VGE) lines in service was skyrocketing – VGE's increased by 103%, from 71 million to 144 million in that same time frame.[38] The Commission must not "fix" the distortions caused by non-cost-based switched access charges through pollution of special access rate structures. Not only would it be economically irrational to recover switching costs from dedicated special access services, it would be virtually impossible to do so in a manner that did not distort existing pricing relationships between special access facilities of different speeds. Collection of lost interconnection revenues from special access services will almost necessarily hamper the global competitiveness and efficiency of U.S. corporations by interfering with their adoption of new technologies and the use of high bandwidth services through the imposition of uneconomic subsidy elements on those services.

V. "Affordability" Does Not Justify Discrimination Against Multi-Line Business Customers and Special Access Subscribers.

There is no evidence that an increase in the Subscriber Line Charge (SLC) would make telephone service unaffordable for residential and single-line business customers. Accordingly, the Commission cannot use "affordability" as the basis for discriminating against multi-line business customers subscribers by implementing an increase in the Subscriber Line Charge that disproportionately allocates any increase to multi-line users. Economic theory and empirical evidence demonstrate that demand for local telephone service is relatively

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37 *Trends in Telephone Service,* at Table 10.1.

38 Federal Communications Commission, ARMIS Report 43-08, Operating Data Report: Table III, YE 2000-2004. Available at http://www.fcc.gov/wcb/eafs/ (accessed May 18, 2005).

inelastic, and that relevant increases in the cost of local service would have virtually no effect on residential or business single-line subscribership levels. According to a study by Hausman *et al.,* "[t]he elasticity of local phone service demand with respect to the basic access price [is approximately] -0.005[sic]."[39] This indicates that "a 10 percent price increase leads to only a 0.5 percent decrease in consumption of local service."[40] In the instant case, this means that a 10% rate increase for local service would mean a drop in telephone subscribership from the current level of 93.5% to 93%. Of course the kind of increase in the SLC that would be required here would likely be much less than 10% of the total local service bill. According to the FCC's most recently released *Statistics of Common Carriers*, total switched access revenues for 2003 (interstate and intrastate combined) were $6.9 billion. Assuming that the entire $6.9 billion in charges is eliminated, and assuming that the entire amount is then recovered through increased subscriber-line charges, the result would be something in the neighborhood of not more than a $4.00 per month increase to single line subscriber line charges.[41] As discussed hereinabove, there is no

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39 Hausman and Shelanski, *Economic Welfare and Telecommunications Regulation: The E-rate Policy for Telecommunications Subsidies,* 16 Yale J on Reg.19, *38 n.85 (1999) (citing Jerry Hausman, *et al., The Effects of the Breakup of AT&T on Telephone Penetration in the United States,* 83 Am Econ Reb. 178 (1993). In the Hausman example, a 10% increase in price and a 0.5% decrease in demand would imply an elasticity of -0.05 and not -0.005 as cited in the text. Were the actual elasticity to be -0.005, a 10% increase in the price of local service would result in a decrease in demand of only a mere -0.05%! We have conservatively assumed that Hausman et al misplaced a decimal point in his measure of elasticity, and that the written example, which falls within a range of reasonableness of other estimates, is the correct measure of local service demand elasticity.

40 *Id.*

41 According to the FCC, End User Access Revenue for 2004 was $10 billion. Dividing by the current average SLC of $5.91 yields $1.7 billion which, when divided into the combined End User Access and Switched Access Revenues of $16.96 billion ($10.02 billion + $6.94 billion), yields $9.98 as the average SLC required to recover all additional switched access revenue. Subtracting out the current average SLC leaves the required increase of approximately $4.05.

evidence that that $6.9 billion needs to be recovered in an alternate manner. Nonetheless, even if the Commission were to implement what most would consider a dramatic increase in the residential and single-line SLC Cap, from $6.50 to $10.00, the increase needs to be evaluated against the average total local service bill, not just as an increase in the SLC. The average price for basic local service most recently reported by the Commission is $24.75 (including the current SLC).[42] This "average" price, however, is not reflective of the average *expenditure* on local service since many local service customers also subscribe to various vertical features offered by the LECs. The average monthly expenditure for local service, reported in the FCC's most recent *Trends in Telephone Service* is $36, per month.[43] This means that, all else constant, even in this most extreme example, an increase in the residential and single-line SLC rate of $4.00 would result in an increase in average phone rates of 11.25%. Using Hausman's local service elasticity value cited above, an 11% increase in the price for local service would result in a decrease of a half a percent in the demand for local service. The most recently reported statistics report telephone subscribership at 93.5% of U.S. households.[44] An 11% increase in the price for

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Federal Communication Commission, ARMIS Report 43-02, USOA Report: Table I-1, YE 2004. Available at http://www.fcc.gov/wcb/eafs/ (accessed May 19, 2005).

[42] Industry Analysis and Technology Division, Federal Communication Commission, *Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service* (2004), at Table 1.

[43] *Id., at Table 3.2 ("Trends in Telephone Service").* With the growth in the adoption of local and long distance service bundles, it is possible that many consumers would consider the cost of their bundled service to be the cost of "local service." In cases such as this, the higher apparent price of local service would make a $4.05 increase in the SLC even less influential on subscribership. For example, for customers paying $49.99 for a local and long distance bundle, a $4.05 increase in the SLC would decrease demand by only 0.4%.

[44] Industry Analysis and Technology Division, Federal Communications Commission, *Telephone Subscribership in the United States*, at Table 1 (data as of Nov. 2004).

local service would drop that number to 93%.[45] Other estimates put the value of local service elasticity of demand closer to -0.3 or -0.2.[46] Under those assumptions, the 11% price increase of local service associated with raising the residential SLC by an amount necessary to recover the full $6.9 billion in revenues being generated by interstate and Intrastate switched access charges would result in a corresponding decrease in telephone subscribership levels of 0.34 percent (from 93.5% to 93.2%) in the case of -0.3 demand elasticity, to a decrease of 0.23 percent (from 93.5% to 93.3%) in the case of -0.2 demand elasticity.

The "average" American household spent only 0.69 percent of its annual income on local telephony in 2003, down from 0.85 percent in 1986.[47] Extrapolating that data to the instant proceeding today , the average residential local service bill would need to sustain an increase of $5.93 in per line charges *per month* (beyond the presently effective $6.50 SLC) before it would account for a greater percentage of average annual household expenditures than local service did eighteen years ago.

This unrebutted evidence indicates that residential customers can afford to pay the same amount on a per number basis as business customers, both

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[45] In point of fact, the analysis above likely *overstates* the level of potential subscribership drop-off, because it does not make any adjustment for the fact that the federal and state *Lifeline* plans would shield many low-income customers from any increase in the SLC rate.

[46] Lester Taylor, "Customer Demand Analysis," in Martin Cave and other, eds., *Handbook of Telecommunications Economics, vol. 1, Structure, Regulation and Competition* (Amersterdam: Elsevier, 2002) pp. 126-127. See, in the same volume, Michael H. Riordan, "Universal Residential Telephone Service," at 447.

[47] Calculations were performed by taking the Average Residential Rates for Local Service in Urban Areas as a percentage of Median Income in Current Dollars; results were extrapolated to represent the "average" American household. *Trends in Telephone Service, FCC Industry Analysis Division, Table 3.1, August 2001. Historical Income Tables – Households,* U.S. Census Bureau, Table H-8, http://www.census.gov/hhes/income/histinc/h08.html (accessed May 18, 2005).

initially and prospectively, should there be an increase in the SLC. Therefore, it would be arbitrary and capricious for the Commission to use "affordability" as the basis for requiring business customers to contribute more, on a per line or per number basis, than residential customers.

VI. The Commission Should Create A "Fresh Look" Opportunity.

If the Commission adopts a new intercarrier compensation mechanism that increases Subscriber Line Charges (SLCs) while access charges paid by long distance carriers decline, customers under multi-year contracts would actually incur higher SLCs while (1) their contractual service rates remain unchanged and (2) their long distance service providers' costs drop dramatically, because of the higher SLCs paid by end users. This situation would be inequitable for end users under multi-year contracts with long distance carriers. It would be even worse than the kind of situation from which the Commission previously has protected *carriers*.

In its seminal 1997 Universal Service Reform order[48], the Commission virtually invited carriers to "adjust" pre-existing contracts because carriers would be required to contribute to the USF.[49] The Commission reasoned that,

> By assessing a new contribution requirement, we create an expense or cost of doing business that was not anticipated at the time contracts were signed. Thus, we find that it would serve the public interest to allow telecommunications carriers and providers to make changes to existing contracts

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48 *Federal-State Joint Board on Universal Service,* CC Dkt. No. 96-45, Report and Order, 12 FCC Rcd 8776 (1997), as corrected by *Federal-State Joint Board on Universal Service,* Errata, CC Dkt. No. 96-45, FCC 97-157 (rel. Jun. 4, 1997), *affirmed in part, reversed in part and remanded in part sub nom. Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999).

49 *Id.,* at 9209.

for service in order to adjust for this new cost of doing business.[50]

If the Commission adopts the unified intercarrier compensation scheme described above, customers under multi-year contracts with long distance carriers collectively would be in a situation even worse than the long distance carriers for whom the Commission showed such great solicitude in 1997. Those carriers were required to make explicit contributions to the USF, but also enjoyed lower switched access charges as a result of the contemporaneous access reform order.[51] In this case, customers under multi-year contracts will still pay their preexisting contract rates for long distance services and higher SLCs, while the long distance carriers with whom they have contracts enjoy lower switched access charges won at the expense of their customers.

The Commission should give long distance customers under multi-year term contracts an opportunity to realize a market-based flow through of the access cost savings that the long distance carriers will enjoy. Customers then would have a chance to offset some of the higher SLC charges that they will confront. The Commission should allow for a market-based flow through of access cost savings by affording customers a one hundred and eighty (180) day “fresh look” window of opportunity within which they may terminate existing contracts. During this 180-day window customers and carriers can negotiate the extent to which long distance service rates should be reduced to reflect the

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[50] *Id.*

[51] *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing End User Common Line Charges,* CC Dkt. No. 96-262, 94-1, 91-213, 95-72, First Report and Order, 12 FCC Rcd 15982 (1997), *aff'd Southwestern Bell Tel. Co. v. FCC,* 153 F.3d 523 (8th Cir. 1998).

carriers lower access costs, which will have been made possible by higher SLCs. If the negotiations do not produce mutually agreeable adjustments (which is possible), the customers should be allowed to terminate the subject contracts without liability, except for charges for services provided.

The Commission has previously used a "fresh look" opportunity to serve the public interest. The Commission gave Tariff 12 customers ninety days from the time 800 numbers became portable to terminate their Tariff 12 contractual packages without liability to "[e]nsure that customers who may be dependent on a specific 800 number cannot be leveraged by AT&T into long-term commitments for Tariff 12 packages that prevent their taking advantage of 800 number portability."

In the present case, the Commission should use a "fresh look" opportunity to give customers a chance to avoid, or partially offset, higher communications costs when their carriers' cost drop – all because of Commission action. In the 1997 Universal Service Reform order, the Commission gave carriers an opportunity to reform contracts to recover additional costs imposed by a regulatory change. Customers should have an opportunity to use the market to avoid some of the cost increase that they would shoulder because of regulatory action. The Commission should not treat end users with less concern than it has shown long distance carriers.

VII. Conclusion

In the foregoing, Ad Hoc respectfully requests that the Commission adopt a unified intercarrier compensation regime that is consistent with the views set forth in these Comments.

Respectfully submitted,

AD HOC TELECOMMUNICATIONS USERS COMMITTEE

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Certificate of Service

I, Michaeleen I. Terrana, hereby certify that true and correct copies of the preceding Comments of Ad Hoc Telecommunications Users Committee were served this 23rd day of May, 2005 via the FCC's ECFS system.

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May 23, 2005